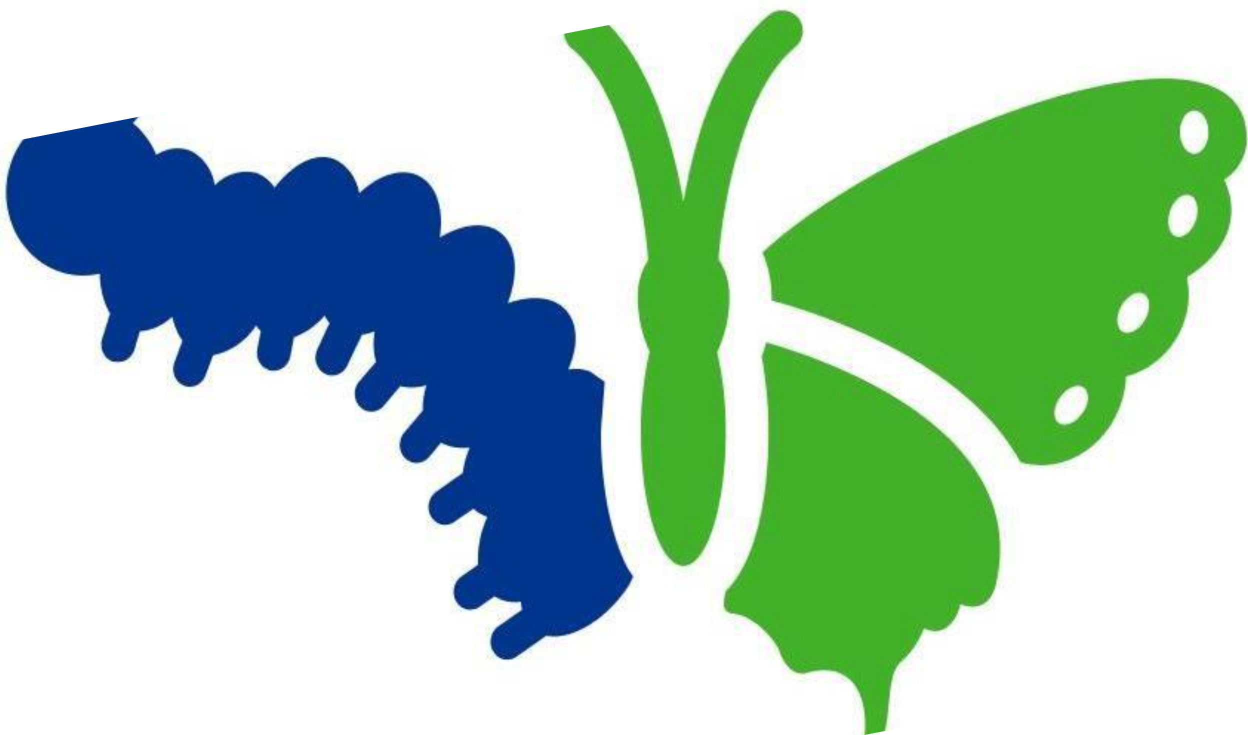
Union Investment

Expertise
Research & Investment Strategy

Of caterpillars and butterflies

The UniESG transformation rating



- **A guide to why and under what circumstances ESG investors should also invest in companies that do not (yet) operate sustainably**
- **UI's methodology for identifying positive and negative candidates**
- **The importance of maintaining a dialogue with companies**

March 2022

1. Introduction

"Sustainability is a process!" This statement expresses a principle that is central to the way in which asset managers should approach the transition to a more sustainable economy. This transition can only be successful at scale if the large number of companies that have not been operating sustainably to date manage to undergo a sustainable transformation *process*. Put very simply, it is more important for 'non-green' companies to go green than for green companies to go even greener. So this is where investors need to apply their leverage. After all, political decision-makers are expecting them to play a significant part in funding this transformation. Sustainability-oriented investment has the greatest impact when it fuels progress towards greater sustainability rather than handing out rewards for sustainability targets that have already been achieved.

In practice, this is not a simple undertaking because it is, of course, much easier to assess the credibility of *achieved* sustainability than that of *envisaged* sustainability. In January 2022, Union Investment therefore started to use proprietary transformation ratings in the investment process for sustainable investments. These ratings essentially represent a qualitative assessment by Union Investment's portfolio managers of how successful a company is likely to be in the coming years with regard to its efforts to become more sustainable. A key characteristic of these assessments is that they are based on a systematic process that is consistent across different economic sectors and updated on a regular basis. The process effectively categorises companies into transformation leaders and transformation laggards. Only those who fall within the former category are eligible as sustainable investment targets.

This document outlines the motivation behind the development of these ratings, describes broadly how the system works (using examples where appropriate), provides an overview of the results that have been produced so far and puts these into the wider context of sustainability-oriented fund and client portfolio management.

2. Why create a transformation rating?

Beyond the belief in the fundamental principle of sustainability as a process, what drives an asset manager to dedicate significant resources to the development and operational implementation of a systematic transformation rating for companies? In essence, the rating constitutes our response to three challenges that professional investors are facing at present (besides the still very diffuse regulatory environment):

- *Conventional ESG data is only of limited use.* Transforming a company to make it more sustainable, including comprehensive decarbonisation, constitutes a change process of a scale that goes well beyond any 'normal' business reorganisation, especially in the manufacturing sector.

After all, it necessitates a massive overhaul of production processes and, in some cases, even substantial changes to the underlying business models. In other words, this transformation can often be very disruptive. In this scenario, data that primarily describes the past and the status quo is of fairly limited use for predictive purposes. The commonly used ESG scores that are provided as raw data by large agencies such as MSCI and ISS, for example, cannot provide a very meaningful answer to the question of how sustainable a company is likely to be *in the future*. Asset managers thus have to tackle the challenge of finding their answers through qualitative, forward-looking analysis.

- *Upside potential is a must.* Most investors do not make sustainable investments purely for ideological reasons – they also want to achieve a reasonable return. The sizeable inflows that this investment category has seen in recent years have largely gone to companies that have already reached a certain standard of sustainability and thus rank among the best in their industry, including notable 'ESG stars'. The problem is that these companies are now likely to be highly valued, if not overvalued, in the equity markets and thus offer limited potential for further price gains.[1] This makes them less attractive for active investors, although they may sometimes be indispensable for diversification. Based on the hypothesis that the capital markets are now applying a kind of 'sustainability premium' to company valuations, it should also be the case that companies whose valuation does not yet (fully) reflect a sustainability premium, and that are subject to a certain risk of not meriting a premium due to uncertainties concerning their transformation process, tend to offer greater upside potential. The most interesting candidates for investors are therefore those businesses that are still at the beginning of their transition from non-green to green (and thus still facing all of the associated risks) – provided, of course, that they will ultimately succeed in transforming themselves. The key to success for asset managers lies in finding systematic and consistent methods for identifying these companies.[2]

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[1] The findings of analyses regarding this aspect do not provide clear-cut answers. Factors of relevance in this context include the analytical approach used, the selection of companies to be analysed and the period of analysis. Over the course of 2021, the performance of many previously highly favoured ESG stars weakened at least in relative terms, and in some cases also in absolute terms. More recent analyses, in particular, thus often present a somewhat ambivalent picture.

[2] Regulation that focuses exclusively on protecting investors against green-washing at all costs and thus deems only those companies eligible that already operate sustainably will prove counterproductive in the long term. That is because it will likely have a detrimental impact on the returns that investors can achieve in this segment, as mentioned above, while also making it more difficult for companies that are not yet sustainable to access the capital they need to transform.

- *Diversification is necessary*. Another argument in favour of considering transformation candidates is one related to professional portfolio construction. In many sub-asset classes and sectors, restricting the security selection to companies that have already achieved a high level of sustainability (i.e. a high ESG score) poses significant challenges, especially with regard to the objective of achieving an appropriate level of diversification. For the purposes of these 'traditional' investment criteria, it may therefore be necessary to use an investment universe that also includes carefully selected transformation candidates in order to be able to construct a genuinely well-balanced, high-quality portfolio. By the same token, portfolios that cannot or choose not to include such transformation candidates may prove disadvantageous in terms of their risk/return profile over the long term.

These three challenges can be summarised in the following requirements profile: What is needed is a qualitative, forward-looking assessment of which companies are most likely to transform successfully and thus offer above-average upside potential in this respect or can improve the diversification of a professional portfolio.

Major asset managers like Union Investment, with a large number of funds and client portfolios, cannot use an approach where this assessment is carried out on a case-by-case basis by individual portfolio managers (for reasons relating to resources, consistency and regulation). Instead, they need to devise and implement a standardised, efficient process for their entire investment platform.

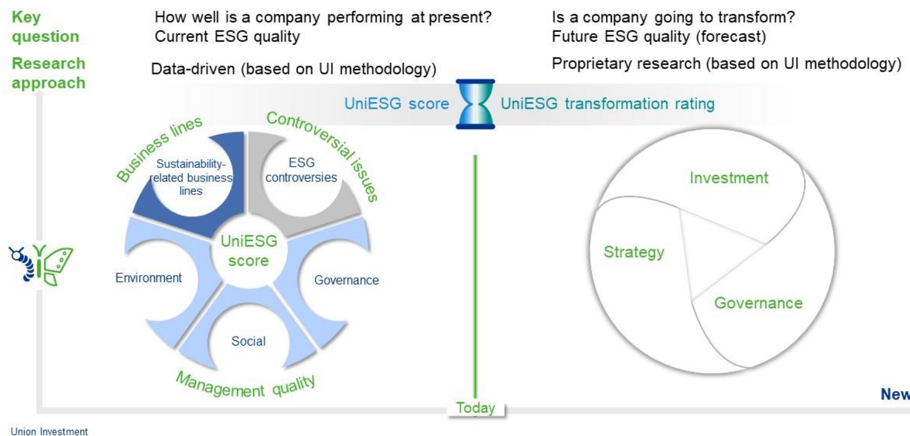
3. The UniESG transformation rating

A (qualitative) rating is the go-to instrument for a multi-dimensional, predominantly qualitative analysis that aims to facilitate comparability across a large number of companies and easy operationalisation.

3.1. ESG scores vs transformation rating

Before we delve into a description of the transformation rating developed by Union Investment, we want to briefly explain how it differs from the concept of ESG scores, which have been widely used in the industry for some time (see also figure 1).

Figure 1: Capturing present and future sustainability



ESG scores essentially answer one question: How sustainable is a company *right now*? They are based on a predominantly quantitative research approach and draw on historical and, in an ideal scenario, current data. ESG scores therefore do not have any predictive qualities. In particular, they do not reflect change processes such as a transformation towards greater sustainability.

The UI transformation rating complements traditional ESG scores and is designed to systematically map and assess a (potential) change process. More specifically, it focuses on forecasting transformation and the likely *future* sustainability of companies.

3.2. Transformation candidates

ESG scores can be generated for a large number of companies because they use a predominantly data-driven analytical approach. By contrast, a qualitative rating is much more resource-intensive and thus needs to be applied in a more focused way. How does Union Investment currently achieve this focus?

Broadly speaking, transformation candidates are companies whose ESG performance is currently (still) mediocre or poor. This is determined primarily on the basis of our UniESG score, which draws on external data from MSCI and ISS and on proprietary research data. In theory, the total population of transformation candidates thus consists of those companies that rank among the bottom 50 per cent within their sector (according to the classification by MSCI and S&P (“GICS”)) on the relevant reference date.[3]

We say ‘in theory’, because this population is then adjusted for companies that are generally excluded from any sustainable investment universe.

[3] Sustainable investment approaches that focus on the top 50 per cent of a sector are also referred to as ‘best-in-class approaches’. Naturally, the composition of the top 50 and the bottom 50 per cent changes over time as some companies climb the ranks while others fall behind. This means the population of transformation candidates is somewhat fluid.

Exclusions mainly relate to controversial business practices (e.g. child labour, forced labour, human rights violations, corruption) and controversial business lines (e.g. banned weapons, armaments, nuclear energy, coal mining and coal-fired power generation, gambling).[4]

Not all, but most of the companies that currently fall under these exclusions are unlikely to be able to transition to a genuinely sustainable business model. This means that they will remain permanently excluded from any sustainable investment universe. An example would be a mine operator focusing on the extraction of fossil fuels, such as Glencore. However, in certain individual cases, companies may have potential to transform (e.g. Anglo American PLC).

For the companies left in the pool of transformation candidates after exclusion criteria have been applied, Union Investment uses the analogy of 'worms' and 'caterpillars' to distinguish between two types of businesses. Worms will always be worms, while caterpillars will transform into (sustainable) butterflies. But looking at a plethora of currently non-green businesses from afar, it is all but impossible to tell which is which. The aim of the transformation rating is therefore broadly speaking the identification of 'caterpillars'. But at a more granular level, it also aims to assess how quickly a caterpillar is likely to turn into a butterfly (speed of transformation) and whether it might turn into a particularly eye-catching butterfly (scale of transformation).

As part of the first phase, Union Investment generated transformation ratings for 280 companies from the total population of transformation candidates.[5] The prioritisation was based on the current relevance of companies to the client portfolios and funds managed by Union Investment. We included relevant stocks from companies in the DAX 40 and the EURO STOXX 50, stocks from companies in the MSCI World with a higher market capitalisation, and a selection of other individual stocks. The latter contingent had a strong bias towards a positive transformation outlook, because even before the implementation of the new rating, investment decisions for sustainable funds involved an assessment of whether a company appeared to have positive transformation potential.

3.3. Structure and process of the transformation rating

The transformation rating is broadly structured in three dimensions (see figure 2):

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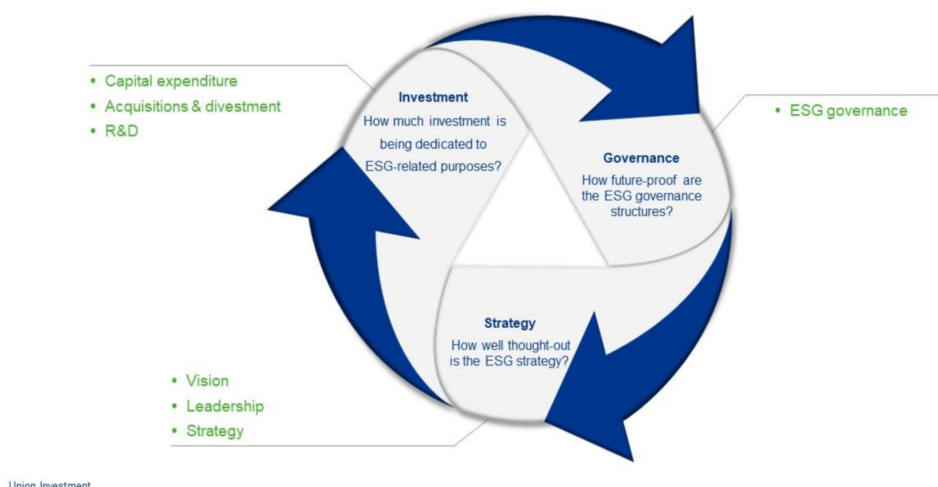
[4] See also Union Investment's Guidelines for Responsible Investment. https://institutional.union-investment.de/startseite-de/Kompetenzen/Nachhaltige-Investments/Engagement.html#Leitideen

[5] This figure includes ratings for 70 companies which, at the reference date, ranked among the top 50 per cent of their sector and thus do not constitute transformation candidates based on the definition of the term. These ratings were produced primarily as a precaution in case these companies slip into the bottom 50 per cent in the future. In addition, *all* companies listed in the DAX, regardless of their current status, were rated due to their particular significance for a

German asset manager such as Union Investment.

- ESG strategy: Is it credible and ambitious? Has the company set itself both long-term and interim targets? Are these targets plausible?
- ESG investment: Does the company invest systematically in measures to improve the sustainability of its business model, in keeping with its strategy?
- ESG governance: Do the corporate management and culture inspire confidence that the company will follow through with its sustainability strategy over the long term and implement it consistently?

Figure 2: Dimensions of the transformation rating



The substantial differences between individual sectors are of crucial significance to the analysis of transformation candidates along these three dimensions. Sectoral factors are particularly relevant in the strategy and investment dimensions and slightly less so in relation to corporate governance matters. Environmental aspects, and especially the topic of decarbonisation, are where we see the greatest sectoral differences. Naturally, companies in the manufacturing sector tend to face much greater challenges in this regard than service providers. But even within the manufacturing sector, there is a huge amount of variation – the problems facing a car maker, for example, are very different from those of a textile company. And then there are also differences in terms of time scales. This is due to factors such as the length of investment cycles (think of power plants, for instance), or the fact that relevant technologies may not yet be available or sufficiently mature (e.g. future drive technologies and fuels for aircraft).

Consequently, the transformation rating needs to take a sector-specific approach regarding both the general transformation potential of the sector as

a whole and the assessment of individual transformation aspects based on key performance indicators (see section 3.3.2.). Not all, but some of these KPIs differ from one sector to the next.

3.3.1. Determination of transformation potential

An important factor for the usefulness of a rating is a benchmark. In an ESG context, this benchmark should reflect a good balance of ambition and realism. A very high and probably unrealistic ambition level that very few companies would be able to reach is just as useless as a very low ambition level that is not viable in the context of overarching sustainability goals. Ultimately, companies from a specific sector should be assessed fairly in consideration of what lies within their respective realm of possibilities. It is also important to bear in mind that for many companies, the process of transitioning to a more sustainable business model will extend over several decades. Defining measurable interim targets can help to manage this. In other words, the benchmarks we set use multiple time horizons. The specific periods that the ‘short-term’, ‘medium-term’ and ‘long-term’ horizon categories represent may vary depending on the sector.

On the basis of this groundwork, step one of the transformation rating involves the assessment of the transformation potential of each sector over the three time horizons. In this context, a distinction is made between the potential for transformation of the company’s products/services on the one hand and its processes along the value chain on the other (see figure 3).

Figure 3: Variation in transformation potential by sector

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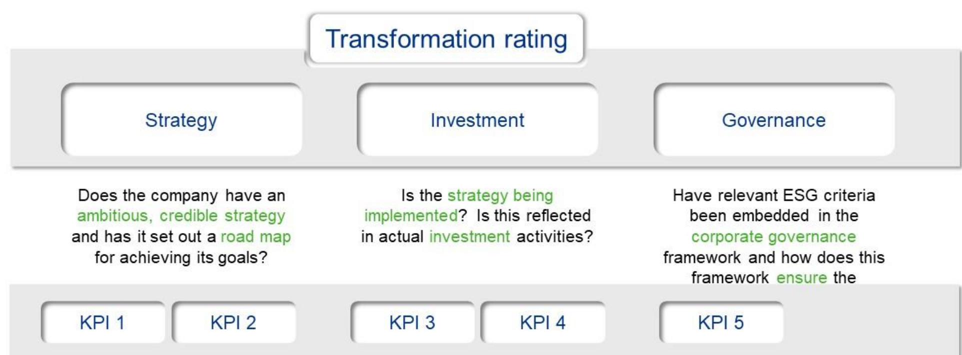
To illustrate this point, let us go back to the example of the mining company (icon in the bottom right corner of figure 3). It has no scope to make its actual product – the raw material that it mines – more sustainable. But it certainly can design the extraction methods it uses, i.e. its ‘production processes’, in more or less sustainable ways. On this basis, mining companies typically have greater (if any) potential for transformation on the process side. In most cases, however, there will be transformation potential at product and process level, although the scope of the potential and the time scale over which it can be realised may differ (see, for example, energy providers and consumer goods manufacturers in figure 3).

3.3.2. Definition of key performance indicators

Based on the transformation potential of a specific sector, key performance indicators (KPIs) are defined for the targeted assessment of the companies in this sector. All in all, we are currently using a set of approximately 80 forward-looking KPIs (see figure 4). Many of these KPIs are used in multiple – and some in nearly all – sectors.

Figure 4: Analysis based on sector-specific KPIs



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This is true, in particular, for KPIs relating to *corporate governance.* Examples of KPIs in this area include:

- How clearly and effectively have relevant ESG targets been embedded in executive remuneration systems?
- Have ESG topics been clearly and firmly included in the allocation of responsibilities at management level?
- How well thought-out are the ESG monitoring and reporting processes?

KPIs in the *ESG strategy (and sustainability of the business model)* dimension vary more across sectors. Examples of frequently used KPIs:

- How compelling are the sustainability-related vision and strategy in general?
- How specific and ambitious are the emissions reduction targets?
- How specific and ambitious are (planned) controls along the supply chain?
- How specific and ambitious are plans for (more) sustainable products?
- What is the company’s strategy for the responsible use of resources such as water, soil and energy?

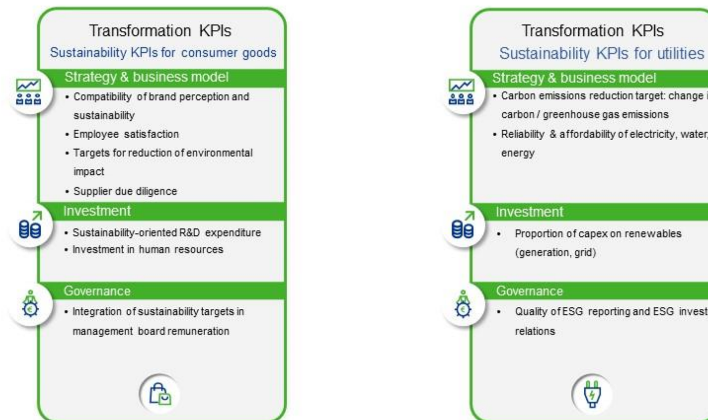
Examples of KPIs used in the *ESG investment* dimension include:

- How much does the company invest specifically in ‘green’ projects, e.g. in connection with renewable energies and resource efficiency?

- How much does the company spend on research relating to its sustainable transformation?
- How much does the company invest in data protection?

Figure 5 shows specific examples of these KPIs for two economic sectors.

Figure 5: Examples of transformation KPIs



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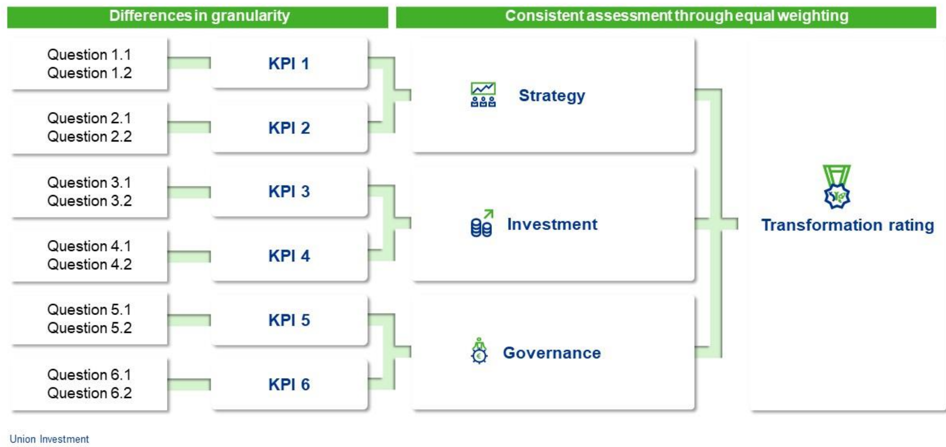
3.3.3. Preparation of the dialogue with companies and evaluation of responses

In the next step, the sector-specific KPIs are used to create questionnaires that help to structure the dialogue with companies and to obtain more granular information. The individual questions or KPIs are then supplemented with ‘transformation performance targets’, which essentially serve to make the aforementioned ‘ambitions’ more specific and measurable in operational terms. The aim is to pre-prepare a kind of template that helps to rate a company’s answer to a specific question on a multi-tier scale.

3.3.4. Evaluation and determination of the transformation rating

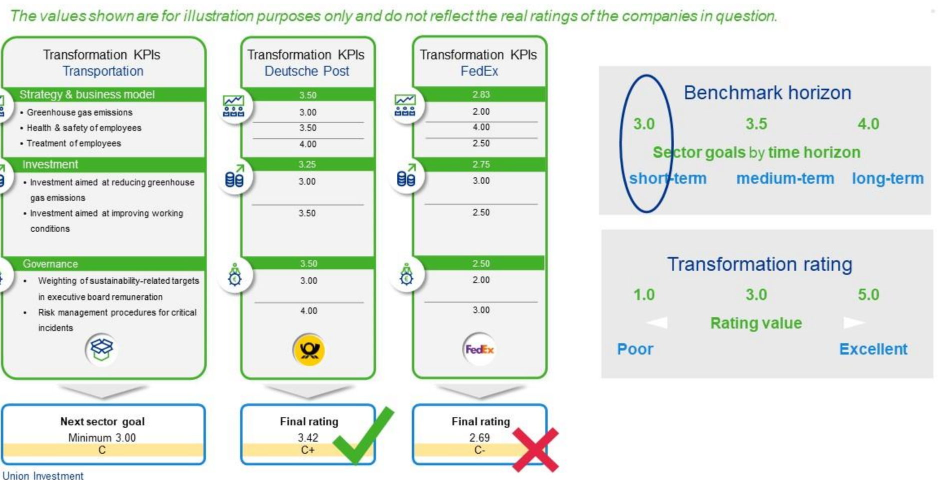
The KPIs are used to aggregate the individual results, derived from the responses and insights provided by the company dialogue, under the three overarching dimensions of the assessment and to produce a transformation rating on this basis (see figure 6).

Figure 6: From the questionnaire to the transformation rating



In this process, the three dimensions are weighted equally, as are the KPIs within each dimension. The final rating is a value between 1.0 and 5.0. Based on their rating value, companies are grouped into transformation leaders and transformation laggards. The latter are excluded from the investable universe for specifically sustainability-oriented funds. Currently, the cut-off has been set at a threshold value of 3.0, which reflects the current ambition level (usually for the short-term horizon). Over time, this threshold value may rise depending on the medium-term and long-term transformation potential of a sector. In other words, companies will need to continue to make progress in the future in order to retain their status as a transformation leader. Figure 7 shows two illustrative company ratings; the values shown are dummy values that do not reflect the true ratings of these companies.

Figure 7: Example using Deutsche Post and FedEx for illustrative purposes



As previously mentioned, the first round of transformation ratings prepared by

Union Investment covered 280 companies. As at January 2022, 195 of these companies (approx. 70 per cent) held a positive overall rating (leader) and 85 companies (approx. 30 per cent) a negative rating (laggard).

The pronounced skew towards positive ratings can be explained by the way in which the companies assessed during the first round were selected. Firstly, 70 companies that actually ranked among the top 50 per cent of their sector were included in the scope of this first round one for procedural reasons (see footnote 4). Due to their high ESG scores, these companies were likely to achieving a positive transformation rating. Secondly, a key criterion for the selection of some companies included in the scope of round one was whether sustainability-oriented funds managed by UI were already invested in them. This also contributed to the bias towards a positive rating outcome.

There was a recurring pattern among most of the companies that fell significantly short of the threshold for a transformation leader rating. These companies had either no sustainability or transformation strategy at all or only a very rudimentary concept, or their existing strategy was not credible. In addition, there was usually a lack of transparency and, in some cases, a general lack of willingness to discuss sustainability-related topics. In most of these companies, senior management had little or no incentive to drive forward a transition to greater sustainability.

Those who missed the positive rating threshold only narrowly (i.e. the ‘best of the laggards’) often do have an ESG strategy in place, but this strategy may be too unambitious or too unspecific and lacking firm quantitative targets. Some companies were also found to have a very inconsistent sustainability profile, with decent scores for some KPIs and poor results for others. This suggests a sustainability strategy that has gaps and is not well balanced.

Naturally, the insights provided by the transformation rating will become more meaningful as time goes by and individual companies undergo repeated assessments. Current plans envisage that companies should be evaluated at least once per year. This will reveal which companies have achieved change – ideally in the form of progress – and which have not. Some companies that are currently classified as laggards did present compelling plans in respect of concrete transformation strategies in the first round of company dialogues and thus have the potential to improve their ratings. On the other hand, repeat assessments will reveal those companies that communicated an ambitious strategy but subsequently struggled to implement this over time. These candidates could lose their status as transformation leaders, which would require sustainability-oriented funds to divest any positions they hold in these companies.

4. Company dialogues and engagement

In section 3, we discussed the underlying methodology and structure of the transformation rating. However, the most essential prerequisite for the preparation of these ratings is the willingness of companies to share the required information. As a minimum, this means that the aforementioned questionnaire needs to be completed diligently. But given the complexity of the individual subject areas, it usually makes sense to supplement the questionnaire with one or more personal discussions.

This type of company dialogue between an active asset manager and exchange-listed companies is not a new concept. For a long time, Union Investment's analysts have been conducting thousands of conversations of this nature every year (currently around 4,000 per year).

However, in the past, these conversations mostly focused on financial and business matters. In recent years, ESG aspects such as corporate governance and environmental issues have also featured more and more prominently in these dialogues. Topics and questions that are specifically geared towards gathering data for the transformation rating are therefore effectively just an addition to the agenda. The outcome of this dialogue is a very comprehensive picture of fundamentals and ESG aspects that guides the investment decisions for sustainability-oriented funds.

Above and beyond the mere collection of data, these conversations increasingly open up another angle for the promotion of sustainable investment. They enable sustainability-oriented investors to inspire change through their communication with companies. Major investors, at least, are now able to do more than simply conduct passive sustainability performance analyses. They have enough weight behind them to try and exert a positive influence on companies as active shareholders or lenders. This approach is referred to as 'engagement'.

Engagement activities span a broad spectrum of intensity. So-called 'activist investors' typically go quite far with the level of influence they (attempt to) exert and can thus appear somewhat aggressive. Union Investment is pursuing a more moderate approach, which could be described as 'active but not aggressive'. Problematic aspects are raised in an open and honest manner and in serious cases, Union Investment may refuse to formally approve the actions of the management board or supervisory board. But all of this is done with a certain degree of restraint.

In the context of the sustainability-oriented transformation of the economy, it is a stated aim of Union Investment to have a positive impact on the scale and speed of this process. The expanded scope of our analysts' company dialogues will therefore go beyond a mere analysis and rating of the current transformation status of businesses. The clear message to companies will be that their eligibility as an investee will be increasingly contingent on their transformation performance. In some cases, concrete steps and measures will be demanded. And, of course, the progress of transformation measures planned by investee companies will be monitored.

Companies will generally be incentivised to adopt more sustainable practices in an effort by UI to consciously shape and drive the economic transformation process. In other words: We want to motivate weaker performers with good potential to 'raise their game' and join the ranks of companies with strong sustainability credentials. After all, we will need as many sustainability champions as possible to have a chance of tackling problems such as climate change successfully. A small elite of companies will not be enough to turn the tide.

5. Conclusion

Always be on the front foot! Union Investment wants to do more than ride the sustainability wave and enjoy the returns it offers. Against the backdrop of our cooperative values, ESG investment has been close to our heart for many years. Union Investment has been driving forward the professionalisation of sustainability-oriented investing for a long time and has thus helped to pave the way for the dynamic growth that this segment is now seeing amid the fight against climate change. The transformation of our economy is becoming increasingly urgent and Union Investment wants to actively support and promote this process. We respect the fact that some companies are only now grasping the full extent of the situation and embarking on their journey towards greater sustainability. Union Investment intends to place a greater emphasis on supporting these companies by providing them with capital – subject to two provisos. One: Their transformation goals have to be credible and actual progress must be measurable over time. And two: Investments in credible transition candidates still have to offer adequate upside potential for our customers. Ensuring that these prerequisites are met requires a highly professional framework, with the transformation rating described in this paper at its core. We feel justified in saying that by adopting this approach, we are taking sustainability-oriented investing to a new level.

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